Office of Chief Counsel Internal Revenue Service

memorandum

CC:MSR:ILD:TL-N-4018-99

date: December 20, 1999

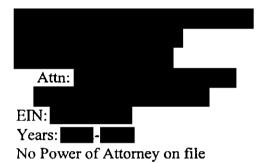
to: District Director, Illinois

Attn: Robert Maio

Case Coordinator E:1102

from: District Counsel, Illinois CC:MSR:ILD

subject: Rebates



I. Issue

Are amounts to be rebated to customers in January of the next tax year based on purchases made by those customers accruable as deductions for the current tax year?

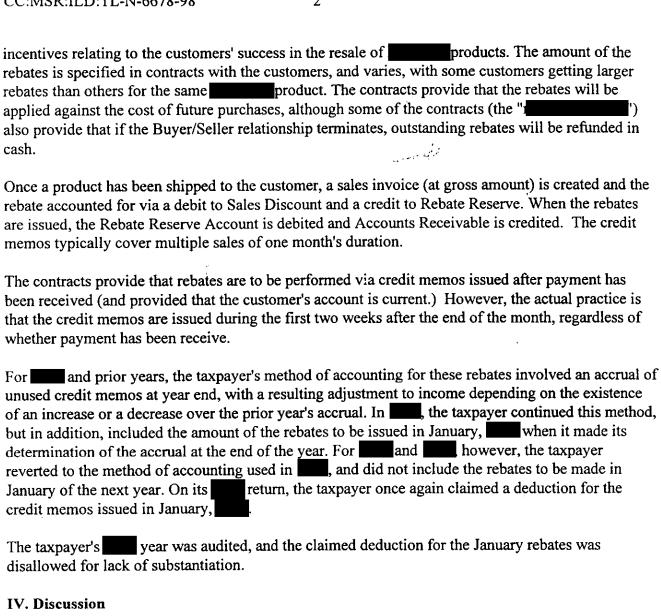
للمدفقين والمداري

II. Conclusion

If a taxpayer properly elects to change to the recurring item exception method of accounting, it may deduct any rebates which are fixed and determinable in the current tax year, if the amounts are actually paid within the time period prescribed by the Code. failed to timely elect to change to this method, and has not otherwise received the Commissioner's permission to change methods. Even if the election had been properly made, the rebates involved in this case may not be accrued unless the taxpayer can show that the customers to whom the rebates were given had made the requisite purchases before the end of the tax year.

III. Facts

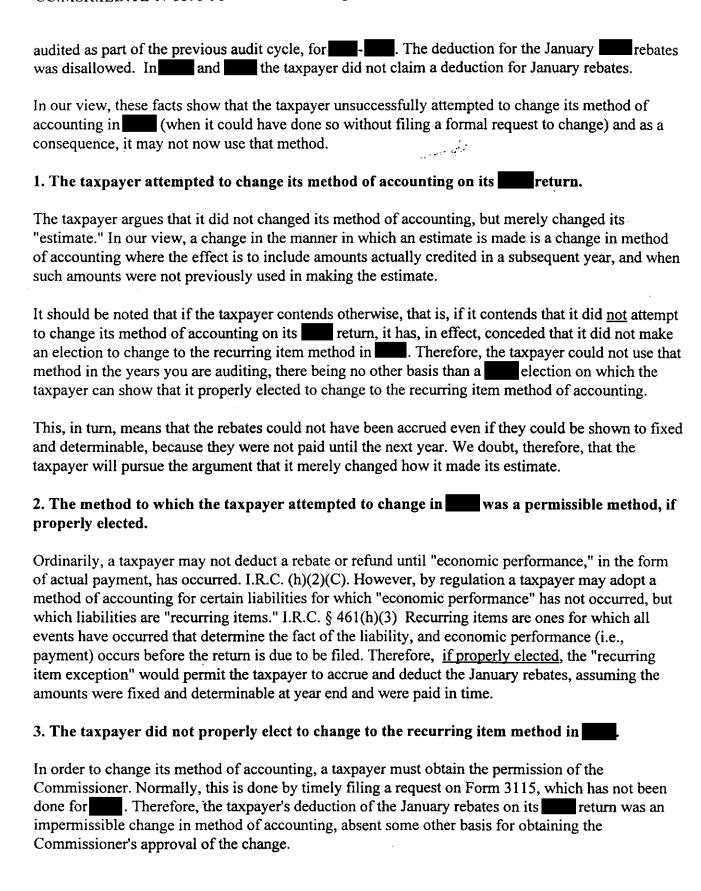
The taxpayer maintains two accounts which are use	d to record the accrual and pa	ayment of rebates to
certain customers. These rebates are referred to as "	<u> </u>	" and are evidently
incentives relating to the customers' success in the r	resale of products.	The amount of the



A. The taxpayer did not properly elect to use the recurring item exception method of accounting.

The regulations under I.R.C. § 461 specifically provide that rebates and refunds are deductible only when economic performance occurs, and economic performance occurs when the rebate or refund is paid or credited. Treas. Reg. § 1.461-4(g)(3). Therefore, rebates and refunds cannot ordinarily be accrued as deductions, even if the amounts involved are fixed and determinable at year end.

Prior to , the taxpayer utilized a method of accounting for rebates under which it maintained a
rebate reserve and made an adjustment to income via Schedule M-1. The January rebates were
thereby taken into account in year in which they were credited. In, for the first time, the
taxpayer included the January () rebates in the year end reserve. The taxpayer's wear was



Treas. Reg. § 1.461-5(d)(2)(ii) provides for an alternative method of gaining the Commissioner's approval of a change in method of accounting to the recurring item exception method. It provides that a taxpayer can elect the change by "accounting for the item" on its original timely filed return. Treas. Reg. § 1.461-5(d)(2)(ii). Treas. Reg. § 1.461-5(d)(3) permits the election to be made retroactively on the taxpayer's or return, so long as the taxpayer (1) makes the election on a return filed before October 7, and (2) complies with the requirements of subsection (d)(2).

Section 1.461-5(d)(3) requires that the election to use the recurring item exception method be elected by "accounting for the item" on its return. Therefore, in order to prove that it made an election for , it is not sufficient that the return reflect that the taxpayer is changing to the recurring item exception method. It must actually have a recurring item properly reportable on the return in order to change to that method.

Treas. Reg. § 1.461-5(b) sets for the requirements for using the recurring item exception. They are that (1) the item is recurring, (2) the amount of the item is not material, (3) the all events test is met, and (4) the item is actually paid within a short time after the year is ended, usually measured by the time the return is filed. It is clear that the taxpayer failed to prove that it met any of these requirements of in connection with the attempted election on its return.

On its return the taxpayer included an amount which it claimed represented the January rebates in its adjustment to Schedule M1. The deduction for this amount, identified as being in Account , was disallowed by the examining agent. The RAR reflects that the basis for the disallowance was that "Based upon the taxpayer's narrative, the taxpayer states that the year end balance is estimated using the December shipments multiplied by the rebate amount. The taxpayer failed to provide any documentation to support that this liability is fixed and determinable at year ended. In addition, the taxpayer failed to demonstrate that any payments were actually made pertaining to the rebate reserve."

This means that the taxpayer failed to show that there was any item on its return which satisfied the all events test ("fixed and determinable"), and it also failed to show that it had actually made the

¹ The taxpayer might contend that its return works as the election required by subsection (d)(2), inasmuch as the second sentence of subsection (d)(2)(ii) refers to elections for years ending before April 7, 1995. However, Treasury Decision 8593, 60 FR 18742 (April 13, 1995) specifically states that the reference to April 7, 1995, does not change the date for making the election by filing a return.

For purposes of this opinion, we are assuming that the taxpayer's failure to use the recurring item method for does not, in and of itself, negate a election. However, subject to the review of our national office, we might want to argue that the failure to use the method in equirement of § 1.461-5(d)(1) that the method be consistently used, and thus, any election was ineffective.

³ As is discussed below, the recurring item method can only be used if the all events test has been met, which includes the requirement that the item be fixed and determinable.

payments within the required time frame. In addition, the failure of the taxpayer to produce evidence in connection with these items also resulted in a failure to show that the rebates or refunds met the other requirements of being "recurring" and of not being material, although the agent did not reach these points in framing the disallowance.

Under these circumstances, the purported election was not properly made. It is as if the taxpayer had failed to even claim the January rebates on the return, but merely recited that it was changing to the recurring item exception method without actually using it. A taxpayer could have only make the election to use the recurring item exception method if it in fact had a "recurring item," and this taxpayer failed to prove that it had such an item on its return.

The tax year of this taxpayer is now closed. The determination of the agent was not appealed. The taxpayer cannot now come forward and contend that the determination of the agent was incorrect.

It should be noted that the taxpayer cannot now amend its return to make the election, since § 1461-5(d)(2)(ii) requires that a tax year election be made on a timely filed <u>original</u> return.

B. The amount of the rebates was not fixed and determinable at year end, so they can not be deducted even if the taxpayer could use the recurring item exception method.

As outlined above, we believe that the taxpayer did not effectively elect to use the recurring item exception method on its return. However, even if we were to concede that point to the taxpayer, and agree that the recurring item exception method can be used on the and subsequent returns, it is our opinion that most, if not all, of the amounts involved do not qualify as "recurring items." This is because in most instances, the fact of the liability cannot be established as of the end of the taxable year, as required by § 1.461-5(b)(i).

Tres. Reg. § 1.461-1(a)(2) prescribes that under the accrual method of accounting, a liability is taken into account when all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.

I.R.C. § 461(h) provides that certain liabilities will not be treated as having satisfied the all events test prior to the time that economic performance has occurred. Treas. Reg. § 1.461-4(g) states that for certain liabilities, payment is required for economic performance, and § 1.461-4(g)(3) includes "rebates and refunds" in that category.

Section 1.461-4(g)(3) states that "In the case of a rebate or refund made as a reduction in the price of goods or services to be provided in the future by the taxpayer, "payment" is deemed to occur as the taxpayer would otherwise be required to recognize income resulting from a disposition at an unreduced price"; i.e., when the rebate is applied for the benefit of the customer.

Therefore, ordinarily, amounts credited or paid for rebates and refunds are deductible only in the year of credit or payment. However, under the recurring item exception method of accounting permitted by Treas. Reg. § 1.461-5, rebates or refunds may be accrued prior to payment if they satisfy the all events test, and if they meet the other requirements of Treas. Reg. § 1.461-5(b).

In order to meet the all events test, the taxpayer must show that the fact of the liability has been established. In the present case, under all the types of rebate contracts, the rebates earned can be utilized only as credit against future purchases. This means that the application of the credits is contingent on a purchase being made subsequent to the one giving rise to the credit. In order to establish the "fact of the liability," the taxpayer must be able to demonstrate that the January rebates it wants to accrue were to be applied against purchases made after the credit was earned but before the end of the tax year. If the subsequent purchase is not made before the end of the tax year, then the amount of the credit is not "fixed and determinable" at year end.

The taxpayer contends that rebates arising under the refund contracts meet the "all events" test in that the obligation to pay the refund is fixed and determinable at the end of the year, regardless of whether a subsequent purchase has been made. The basis for this claim is that the rebates were subject to refund without regard to any subsequent purchases, because the refund contracts required the taxpayer to refund the rebates if the customer stops buying from the taxpayer. Thus, the taxpayer contends, unlike the other rebates, there was not a contingency for payment that had not been satisfied in

We do not agree with the taxpayer that the existence of a refund is fixed and determined at the end of the year, unless the taxpayer can show that the customer had terminated the Buyer/Seller relationship before the end of the year and thus was entitled to a refund. This is because, under the contract, the amount that the taxpayer is required to refund is not an amount certain, but rather, the balance owed after taking into account amounts credited against purchases. If there is a balance of \$100 in the customer's refund account as of December 31, the end of the tax year, and the taxpayer continues as a customer but does not make another purchase until the next November, when it buys \$60 worth of merchandise, the amount of the refund will be reduced if the customer then decides to terminate the relationship.

This opinion is subject to review in our national office, which normally should occur within ten working days of the date of this memorandum. We will advise you if the national office recommends any changes in this opinion.

Richard A. Witkowski District Counsel

HARMON B. DOW

Special Litigation Assistant

أمراقمة أمايين

cc: Assistant Chief Counsel (Field Service) CC:DOM:FS
Assistant Regional Counsel (Tax Litigation) CC:MSR:TL
Assistant Regional Counsel (Large Case) CC:MSR:LC:CHI-POD